Philippine Economic *Outlook*

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Inside...

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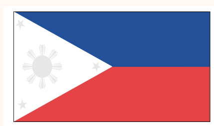
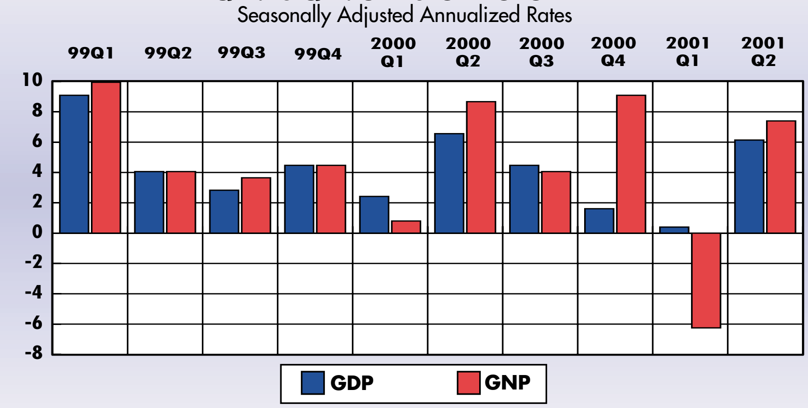
Introduction



The impact on the global economy of the September 11th terrorist attacks on the United States was beginning to manifest itself in Asian markets and in the Philippines as this *Outlook* went to print. Philippine economic indicators, which had been volatile in recent months, continued a downward trend, and the uncertainty after September 11 added to the country's economic vulnerability. With a weak growth outlook, decelerating exports, a sizable fiscal deficit, and a weakening peso, the Macapagal-Arroyo administration was forced to revise its targeted GDP growth range downward to 3.3% – 3.8% growth from previous 3.8% – 4.3% growth estimates. Private sector analysts are more conservative. Our own estimate is that the Philippines can reach real full-year GDP growth of 2.5% – 3.0% in 2001. If the U.S. enters a prolonged downturn, or if the Arroyo administration strays from its reform agenda, the situation could deteriorate further.

Government officials tightened their rein on expenditures to deal with reduced revenues and allowed the Arroyo Administration to contain the fiscal deficit well within the ceiling programmed for the first seven months of 2001. Continued success in this area will depend on enhanced tax collection efforts in the remaining part of the year. Consumer inflation, which averaged 6.6% during the first eight months of 2001, is within the government's target range for the full year and barring severe pressures on food commodities, oil prices, and the local currency, year-on-year inflation is expected to slow further in the months ahead. The unemployment rate averaged 11.6% during the first three quarterly labor surveys. This year's full-year unemployment rate is likely to remain at double-digits, given more modest economic growth prospects for 2001. The pressure to generate jobs is all the more pressing as the growth in labor force participation increases. Lack of employment opportunities continued to push skilled Filipinos to seek opportunity abroad, despite the global slowdown.

QTR.-to-QTR. GDP & GNP GROWTH
Seasonally Adjusted Annualized Rates



President Arroyo followed her State of the Nation speech in July, which focused on the need to promote macroeconomic stability with equitable growth led by the private sector, with travel in Asia promoting the Philippines as an investment destination. Foreign investment has plummeted over the past year due to a succession of domestic crises, including the impeachment trial of former President Estrada, military action in Mindanao, kidnapping incidents in Mindanao and elsewhere, and allegations of drug trafficking and money laundering by public officials. The global semiconductor glut has also lowered investor interest. Equally challenging is an ambitious legislative agenda that seeks to strengthen the banking sector and develop the country's financial markets, while promoting strategic sectors, including information technology, telecommunications, and tourism. Even if passed, it cannot be assumed that legislation in these areas would be effectively implemented.

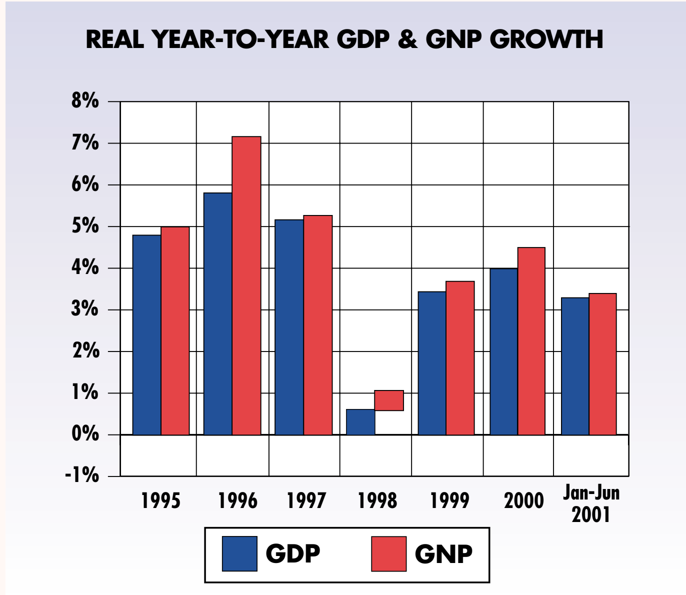
Donor country representatives meeting in Manila in September praised the government's Mid-Term Economic Plan, the 2002 budget, and the country's Mid-Term Public Investment Plan. But they openly questioned the economic growth assumptions as too optimistic, noted the lack of detail on how the private sector would participate in infrastructure development, and were skeptical on whether new procurement rules would be implemented.

Casting a large shadow over the government's economic initiatives was the festering inability to bring the terrorist Abu Sayyaf group under control. Allegations of collusion between the Armed Forces of the Philippines and the terrorist group further undermined the government's authority. Lack of success on the law and order issue threatened to limit the success of all other initiatives. Pervasive corruption in government agencies, particularly the Bureau of Internal Revenue, also poses a significant challenge to the Arroyo Administration.

Despite these many challenges, there are bright prospects in some areas. U.S. companies in telecommunications, consumer products, retail trade and other sectors report high growth rates in the past two quarters and continued optimism about business prospects for the Philippines and the region.

Actions to Combat Terrorism

Following the September 11 terrorist incidents in the United States, President Arroyo announced a comprehensive package of steps to combat terrorism and, on September 29, signed into law an anti-money laundering bill that will assist international efforts to cut off funding for terrorists and terrorist organizations. The new law, which appears to meet standards of the Organization for Economic Cooperation and Development's (OECD) Financial Action Task Force (FATF), criminalizes money laundering, requires financial institutions to report suspicious transactions, and provides authority to freeze accounts, examine transactions, and prosecute violations. The law also calls for cooperation with foreign states in prosecuting money laundering offenses. The Philippine Government was also exploring bilateral efforts to combat terrorism under the US-Philippines Mutual Legal Assistance Treaty, and considering ratifying UN conventions targeting the financing of terrorism.

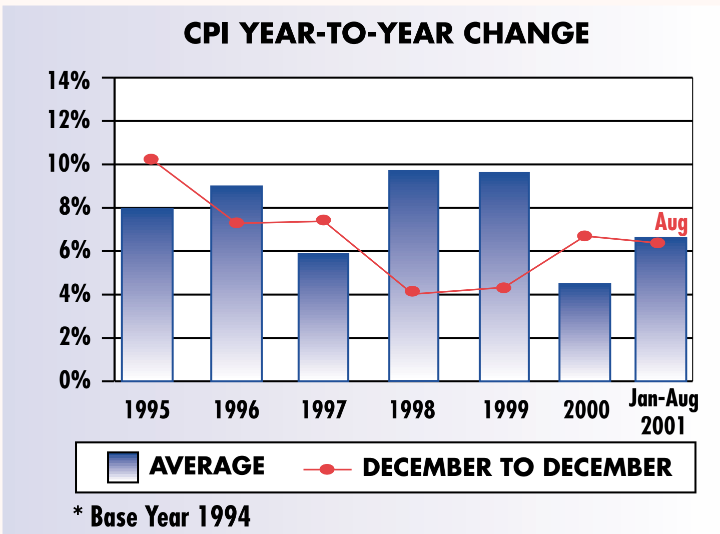


Output and Inflation

Seasonally adjusted figures show that quarter-on-quarter Gross Domestic Product (GDP) growth — up barely 0.4% during the last quarter of 2000 — hardly increased during 2001's first quarter because of a 0.9% decline in industrial sector output. However, the second quarter saw a stronger, seasonally adjusted GDP growth rate (1.5% quarter-on-quarter), reflecting improved performances by the agricultural and industrial sectors.

According to the more widely used gauge of overall economic activity — measured as the year-on-year change of seasonally unadjusted data — real GDP grew by 3.2% and 3.3% during the first and second quarters, respectively. Gross National Product (GNP) expanded by 3.3% (first quarter) and 3.5% (second quarter). The second-quarter growth performance surpassed even government expectations. Government economic planners had predicted year-on-year GDP growth of between 2.8% and 3.0% during the April to June period — which many private analysts had considered optimistic.

On the production side, Philippine GDP more or less sustained its first quarter expansion because industrial sector growth accelerated from 1.6% to 3.6%. That acceleration made up for the slower pace recorded by agriculture (from 3.5% to 2.5%) and services (from 4.2% to 3.4%). The industrial sector's stronger expansion came almost solely from the construction sub-sector (which reversed from a 4.0% first-quarter decline to a second-quarter 5.9% increase). With private construction still in the doldrums, that growth came entirely from the public sector — which government analysts partly attributed to the higher output recorded by a number of build-operate-transfer projects. They also cited the release of government funds for capital spending after the delayed (March 2001) enactment of the national government's 2001 budget. On the other hand, the manufacturing sub-sector — which contributes over 70% to overall industrial sector output — sputtered from 3.4% to 2.6% growth (its lowest recorded year-on-year increase since the fourth quarter of 1999). The utilities sub-sector's growth performance decelerated from 4.0% during the first quarter to 3.5% during the second quarter. The service sector expanded by a more modest 3.4% pace (after growing 4.2% year-on year during the first three months of 2001).



On the demand side, exports (measured in real peso terms), personal consumption, government consumption, and capital formation all posted weaker year-on-year rates of expansion relative to their respective first-quarter growth performances. Consumer spending slowed from 3.5% to 3.2% growth. Second-quarter government spending declined 2.4% in real terms after expanding 3.0% year-on-year during the first quarter. Capital investments decelerated from 5.0% (first quarter) to 3.4% (second quarter) growth despite a rebound in public sector construction spending. Second-quarter investments in durable equipment stagnated year-on-year after mustering a 0.7% year-on-year increase during the first three months of the year. The second quarter also saw net inventory withdrawals after a first-quarter net build-up, contributing to the reduced second-quarter growth pace in total capital formation. Exports of goods and non-factor services, hard-hit by currently weak export markets, contracted by 4.1% year-on-year in real peso terms. However, a larger share of overall demand was supplied by domestic economic output during the second quarter relative to the first quarter, explaining the sustained second-quarter expansion of real Philippine GDP.

On a cumulative first-semester basis, real GDP and GNP expanded by 3.3% and 3.4% year-on-year from their corresponding 2000 six-month levels. The comparable first-semester 2000 year-on-year growth rates were 3.8% and 4.0%, respectively. Only the agricultural sector posted a stronger first-semester expansion (3.0% year-on-year) than recorded during the first six months of 2000 (2.3%). Compared with the previous year, the industrial sector put in a weaker first-semester growth rate (2.7% versus 3.9%), as did the service sector (3.8% versus 4.4%). In the industrial sector, only the construction sub-sector put in an improved performance (1.3% versus -6.7%, reflecting the second quarter 2001 acceleration in government construction activity). In the service sector, all major sub-sectors (i.e., transport and communications, trade, finance, real estate, and private services) posted lower growth performances than in the first half of 2000. On the demand side, personal consumption (up 3.4%, slightly higher than 3.2% the year before) and capital formation posted improved rates of expansion. Total capital investments grew 4.3% (versus 0.9%), benefiting from the first-quarter 2001 build-up in stocks and the second-quarter 2001 acceleration in government construction spending. These offset the slowdown in durable-equipment outlays (up 0.3% versus 4.7%). However, exports — which sputtered from 13.9% to 0.6% growth in real peso terms — emerged as the first-semester's major growth dampener demand-wise.

Since the June 2001 edition of the *Philippine Economic Outlook*, the Macapagal-Arroyo administration has revised its 3.8% – 4.3% targeted GDP growth range downward to 3.3% – 3.8%. Government economic planners no longer aspire for the upper end of that targeted range but expressed confidence that the economy's first-semester 3.3% GDP expansion could be sustained into the second half of the year. Private sector analysts are more conservative. We note that the overall year-on-year economic expansion posted during the second quarter was not broad-based and that most major components of production and demand had, in fact, slowed. Hopes have dimmed for a quick turnaround in currently depressed export markets. Revenue difficulties have prompted government budget and finance officials to tighten their rein on expenditures. It remains to be seen whether the government will be able to sustain the second-quarter acceleration in government construction activity. Low inventory levels (suggested by successive net inventory withdrawals from 1998 to 2000) may provide some impetus to growth but, overall, over-capacity and the longer-than-expected recovery in private construction activity may hold back more robust investment levels in the near-term. The recent terrorist attacks on the U.S. have further added to the cloud of uncertainty. It is difficult to say at this early stage how deep an impact this recent development and unfolding events will have on economic growth prospects, particularly during the fourth quarter. Our current reading is that it would still be reasonable to expect real full year GDP growth of between 2.5% – 3.0%.

Year-on-year consumer price inflation, which averaged 6.8% during the first four months of 2001, averaged 6.6% from May to August. For August alone, the posted inflation rate was 6.3% — the lowest thus far since December 2000. Year-on-year inflation averaged 6.6% during the first eight months of 2001, within the government's targeted 6% – 7% range for the full year. Barring severe pressures on food commodities, oil prices, and the local currency, year-on-year inflation is expected to slow further over in the month ahead. Prices in the coming months will also be coming off a relatively high 2000 base (during which inflation rose more rapidly to reflect sharp increases in oil prices and the depreciation of the local currency).

Labor and Employment

The country's labor market showed signs of modest improvement, despite a sluggish domestic economy weighed down by political turmoil. Employment rose to 29.2 million in April 2001, an increase of 7.2% from April 2000. This figure can be attributed in part to campaign-related spending activities in the May national elections, and to the influx of new college graduates. The agricultural, fishery and forestry sectors bounced back strongly from their decline in the past year, recording a 10.9% annual growth rate as of April 2001. Growth in employment was felt in all regions of the country, reversing the trend from a year before. It is nevertheless worth noting that 85% of the expansion in the number of employed persons between April 2000 and April 2001 represented increases in unpaid family workers and self-employed workers. This suggests that labor force entrants may have moved to the informal sector because of limited opportunities in the formal economy.

The unemployment rate declined to 13.3% from 13.9% in April 2000. However, the actual number of unemployed persons increased slightly, reflecting the growth in the labor force participation rate from 66.5% in April 2000 to 69% in April 2001. In nominal terms, the size of the country's workforce grew by 6.4% over the previous year, to 33.6 million. Notable declines in unemployment occurred among women (15.9% to 14.3%) and persons in the prime working age of 25 to 54 (8.3% to 7.8%). The unemployment rate worsened, however, in three regions in Mindanao.

Despite the global slowdown, deployment of overseas Filipino workers rose by 1.5% to 390,695 in the first five months of 2001, from 384,906 in the same period last year. Both land-based (302,042 to 305,855) and sea-based (82,864 to 84,840) deployment increased in the first five months of 2001.

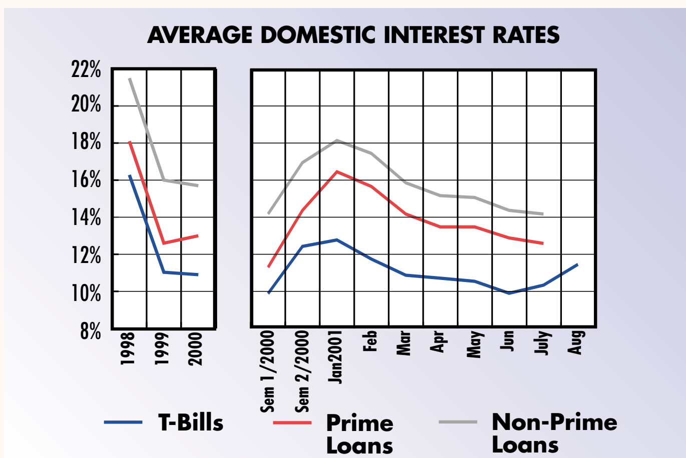
The number of strikes as of July 15 was down by 25% (32 to 24) from the same date in 2000. This is attributed in part to a more proactive approach taken by the National Conciliation and Mediation Board.

Five regional tripartite wage boards, including that of the National Capital Region (NCR), began holding public consultations in August in connection with wage increase petitions. In the NCR, the mainstream Labor Solidarity Movement (LSM) petitioned for an across-the-board P77 increase in the daily minimum wage, which now stands at P250. The LSM cited the erosion of the purchasing power of workers arising from the increase in the price of goods and services in recent months. Moderate labor groups in the central Visayas are seeking an across-the-board P50 hike. The Department of Labor and Employment (DOLE) indicated that wage boards in other regions may increase the daily minimum wage even without petitions. Militant labor groups are seeking an across-the-board minimum wage hike of P125 per day. DOLE officials have stressed that a P125 wage increase would hurt more workers in the long run and could lead to a steep rise in unemployment.

Meanwhile, the Philippine Overseas Employment Administration (POEA) in August announced stiffer penalties for employment agencies violating recruitment rules and regulations. On orders from Secretary Santo Tomas, POEA is also focusing on improving and streamlining its services and on winning ISO certification by the end of 2001.

In June, Labor Secretary Patricia Santo Tomas was elected President of the 89th International Labor Conference in Geneva, Switzerland. In her first address to the tripartite conference, Santo Tomas called on ILO members to focus on the protection of sectors vulnerable to the effects of globalization, including migrant workers, child workers and the informal sector. She asked the international community to focus on ensuring minimum standards, especially in developing countries, to address the problems brought about by a globalizing economy.

In July, Secretary Santo Tomas told an audience at the University of the Philippines School of Labor and Industrial Relations that job generation was a central concern of the



Macapagal-Arroyo administration. She said the government's Medium Term Philippine Development Plan had been revised to incorporate a new chapter on employment. The employment plan included strategies that would raise productivity through economy-wide modernization schemes, and upgrading of labor supply through investments in education and skills acquisition.

Financial Markets

The Bangko Sentral ng Pilipinas (BSP, central bank) reduced overnight rates by 50 basis points in May (to 9% and 11.25% for borrowing and lending rates, respectively), following a similar cut by the U.S. Federal Reserve Open Market Committee. This brought the total reduction in overnight rates since December 2000 to 600 basis points. Loan growth remained lethargic despite the successive interest rate reductions. The BSP subsequently switched to a monetary tightening mode as downward pressure on the peso accelerated, noting that excess liquidity was flowing into foreign assets and posed upside risks to the inflation outlook. The BSP did not follow suit with further U.S. rate cuts between June and August and abolished a tiered interest rate system for placements with the BSP (which it had earlier adopted to encourage more active bank lending). The BSP also raised reserve requirements on deposits and trust liabilities of commercial banks and non-banks with quasi-banking functions on July 27 and August 10 by a total of four percentage points. The higher reserve requirements were imposed on "liquidity" reserves (which, unlike statutory reserves, earn market-based yields) to minimize upward pressure on domestic financing costs.

Treasury bill rates, which had softened with declining overnight rates during the first 5-1/2 months of the year, began inching up with the BSP's monetary tightening bias. The benchmark 91-day T-bill rate — which bottomed out at 8.306% during the June 18 weekly T-bill auction — had inched up to an average rate of 9.590% during the third week of August. Rates for the longer-term 182- and 364-day bills bottomed out a week earlier on June 11 (9.700% and 10.623%, respectively) and then inched up until August's last weekly auction — averaging 11.940% (182-day bills) and 12.950% (364-day bills). T-bill rates moderated during the first two September auctions — 91-day T-bills averaged 9.454%, 182-day bills 11.803%, and 364-day bills 12.689% on September 10 — responding to August's more moderate inflation numbers and a more stable foreign currency. In the bond market, the Treasury continued with its strategy of reissuing older series of two, three, and five-year bonds to maximize borrowings from the shorter end of the yield curve. The strategy has helped the government contain interest costs but has raised longer-term concerns over the potential danger of bunching maturities if prolonged indefinitely. Treasury officials have announced that the government intends to resume issuing longer-term paper (including ten-year bonds) during the fourth quarter.

Commercial banks' published loan rates inched up with the BSP's monetary tightening bias, but increased more moderately than the benchmark 91-day T-bill rates. The numbers suggest that risk-averse banks remained reasonably liquid after the BSP's monetary tightening moves because of limited lending opportunities. Average prime rates were at about 12.97% as of mid-September and non-prime rates at 14.54%, compared with their respective end-June levels of 12.67% (prime) and 14.26% (non-prime).

BSP officials indicated in early September that an improved inflation outlook and a more stable peso have given the Philippine Monetary Board more latitude for monetary easing. We expect a downward bias on domestic interest rates in the short-term, taking the cue from expectations of further U.S. rate cuts and from more moderate inflation figures. Sustaining a downward path will, however, depend on the government's ability to keep the fiscal deficit under control as economic growth slows; and on how unfolding developments after the terrorist attacks on the U.S. affect world oil prices and the local currency.

Saddled with NPLs and a growing portfolio of foreclosed assets, banks remained cautious lenders, while weaker economic prospects translated to conservative credit demand. As of July 2001, outstanding loans of the commercial banking system (inclusive of inter-bank credits) were down 3.3% (P57.0 billion) from the end of 2000 and grew barely 3% (P45.3 billion) year-on-year. On the other hand, non-performing loans (NPLs) outpaced credit expansion, increasing by 13.3% (P32.6 billion) since the beginning of the year and by nearly 20% (P45.5 billion) from July 2000's comparable level. As a result, the ratio of non-performing loans to the commercial banking system's total loan portfolio (i.e., NPL ratio) has risen to new highs since February, hitting 17.7% in July. Foreclosed assets also expanded rapidly, increasing by 13.7% (P17.6 billion) between end-2000 and July 2001 and by 28% (P32.1 billion) year-on-year. As of July, the commercial banking system's portfolio of non-performing assets (NPAs, the sum of NPLs and foreclosed properties) stood at P424.1 billion (equivalent to about $8.5 billion), higher by 13.4% from the end of 2000 and by 22.4% from its year-ago level.

Bankers doubt that non-performing loans have peaked, noting that businesses are struggling with both weaker export and domestic markets. Overall, the Philippine banking system's generally healthy capital adequacy ratios (16.5% on average, versus the BSP's 10% statutory floor) and adjustments in loan-loss reserves (which increased from 43.5% of outstanding loans at the end of 2000 to 44.6 as of mid-2001) have helped the banking system avoid systemic problems. Still, it should be noted that while systemic risk is small, significant troubles at any major commercial bank could lead to a swift reversal of depositor sentiment, and the resulting strain on the system to service withdrawals could be substantial. Looking forward, a continued deterioration in asset quality could increasingly constrict banks' margins, liquidity, and overall profitability. A number of banks are exploring setting up or using the services of asset management companies (AMCs) to clean up their non-performing accounts. The government has said that it will look into possible policy support measures to encourage such private sector-led initiatives.

The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium (since September 1999) on the issuance of new bank licenses. From April to August 2001, the BSP approved 5 mergers involving 2 commercial banks, 2 thrift banks, 4 rural banks, and 2 non-bank financial intermediaries. This brings to 6 the acquisitions and/or mergers approved since the beginning of the year. The BSP has approved 34 acquisitions and/or mergers thus far since the Asian crisis (involving 27 commercial, 17 thrift, 10 rural banks, and 6 non-bank financial institutions). Ten commercial, 29 thrift, and 188 rural banks remain short of minimum capitalization levels, suggesting there is room for further consolidation. About 19 acquisition and/or merger proposals are pending with the BSP. The Bangko Sentral ng Pilipinas has also demonstrated greater resolve in weeding out weak financial institutions. Smaller-capitalized thrift and rural banks (which constitute about 10% of banking system assets) have been more severely affected by the shakeout. Eight more rural banks closed from January to August 2001 — for a total of 110 bank closures since mid-1997 (involving 2 commercial, 13 thrift, and 95 rural banks). Urban Bank (one of two commercial banks that closed during the Asian crisis) was turned over to its new owners (led by Export and Industry Bank, another commercial bank) in August — making it the first ever bank closed and later rehabilitated by another financial institution.

On the anti-money laundering front, the Financial Action Task Force (FATF) recommended last July that its members impose countermeasures on the Philippines and two other "non-cooperative countries" unless they enact significant anti-money laundering legislation by September 30, 2001. The government submitted draft legislation to FATF members for their review and subsequently introduced the proposal in the Philippine Congress in August. Following the September 11 terrorist attacks in the United States, and after an extensive lobbying campaign led by President Macapagal-Arroyo, an anti-money laundering bill was passed and signed into law on September 29. The legislation, which appears to meet FATF concerns, seeks to criminalize money laundering, institutionalize suspicious transactions reporting (currently contained in BSP administrative circulars), and to relax overly stringent bank secrecy laws.

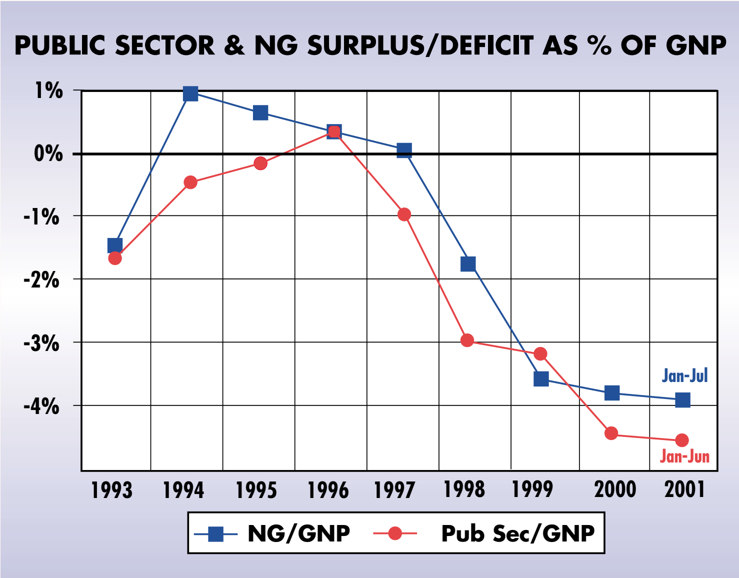
In the equities market, stock prices generally continued to falter on thin volumes, mired by external and domestic news and developments. Increasing domestic interest rates, a new round of Abu Sayyaf hostage takings, and escalating peace and order concerns combined with weak corporate-profit reports and uncertain global and domestic economic growth prospects. The Philippine Stock Price Index (Phisix) managed to close above the 1,400 mark during most of May and June. In July, however, the index slipped below the 1,400 level and, by the third week of August, had broken the 1,300 barrier — sinking to a ten-month low on September 4 (1,252.58). The Phisix improved for a few days on selective bargain hunting but quickly retreated to 10-1/2 month lows after the terrorist air attacks on the U.S. dealt a practically comatose market yet another blow. The Phisix closed at 1,236.42 on September 14, down 17.3% from end-2000.

Already depressed stock market trading volumes thinned to below P200 million the day after the U.S. tragedy struck — the lowest in the seven-year history of the unified Philippine Stock Exchange (PSE). Volumes have since increased over the P200 million mark but thin volumes and the recent added uncertainty could spell a further shakeout. About nine PSE member-firms (mostly foreign brokerages) have ceased or suspended operations since the beginning of the year. On a more positive note for the longer-term transparency and stability of the Philippine equities market, the PSE took the first step towards the bourse's demutualization by converting to a stock corporation on August 8 (one of the major reforms stipulated in the Securities Regulation Code of 2000, SRC). The bourse intends to offer its shares to the public in another year or two to comply with an SRC provision preventing any industry or business group from controlling more than 20% of an exchange's voting rights.

Fiscal Performance

As of July 2001, the Macapagal-Arroyo administration managed to contain the national government's fiscal deficit to P82.6 billion, well within the P93.6 billion ceiling programmed for the seven-month period. This was achieved by reining in an already tight expenditure plan (by P18 billion as of July) to offset persistent revenue shortfalls. Seven-month revenues were P7.1 billion short of target. That under-performance would have been larger if not for higher-than-programmed non-tax inflows (mainly Philippine Treasury investment earnings), which partially offset a P15.3 billion shortfall in tax revenues. The unmet tax collection goal reflected both the economy's slower-than-projected expansion and tax administration problems. Bureau of Internal Revenue (BIR) collections, off the seven-month target by P13.3 billion, have been especially problematic. Latest available data estimated the national government's tax-to-GDP ratio (a measurement of tax collection efficiency) at barely 14% during the first half of 2001 — down from 2000's first-semester 14.8% performance and significantly short of the 15.4% ratio originally targeted for the 2001 full year.

Government fiscal managers concede there is little room to cut expenditures further during the rest of 2001. Neither does the national government expect to recover its seven-month



tax collection shortfall in the months ahead. The government's fiscal team nevertheless hopes to keep within the P145 billion deficit envisioned for the year given unexpectedly higher non-tax receipts thus far and by preserving some P10 billion in full year expenditure cuts. Nevertheless, keeping within the full year deficit ceiling will not be without challenges, hinging heavily on the BIR's ability to meet its second-semester collection goal and on attracting takers for some P9.5 billion worth of government-owned assets slated for sale before the year ends. The government is banking on a number of administrative reforms to improve internal revenue collections, including an electronic metering scheme for documentary stamp taxes, a compromise tax settlement program, intensified tax audits, and tighter withholding tax regulations.

The consolidated public sector (which includes government-controlled firms, social security agencies, local government units, and the Bangko Sentral ng Pilipinas) recorded an P82.5 billion deficit during the first half of 2001 (equivalent to 4.8% of GDP). That level was lower than the P90.3 billion level programmed for the six-month period, reflecting lower deficits posted by the national government and by public sector firms. Nevertheless, government fiscal planners now forecast the consolidated public sector deficit to tread towards a P165 billion (4.6% of GDP) year-end level, breaching the original P141.6 billion (3.9% of GDP) program. This expectation reflects wider deficits for the government corporate sector and narrower-than-expected surpluses by government-run social security agencies. Looking forward, the privatization of the National Power Corporation (Napocor, the government's debt-saddled power generating company) under the provisions of the recently enacted Electric Power Industry Reform Act would be a positive step towards stabilizing overall public sector finances. Another important challenge the government faces is to address threats to the long-term viability of state-run pension funds (the Social Security System and Government Service Insurance System) arising from imbalances between contributions received and benefits paid (which pose a potential drain on national government resources).

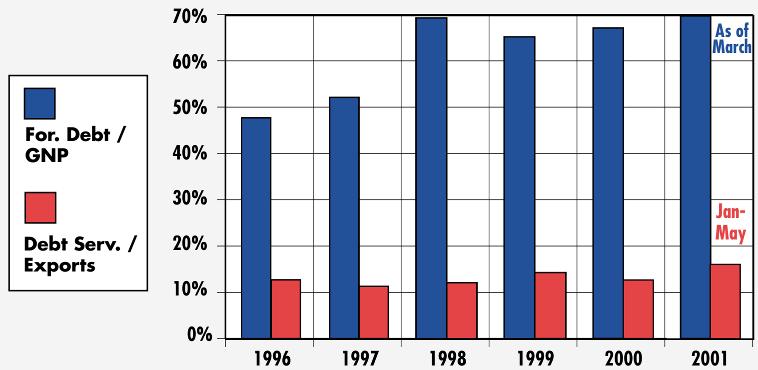
In August, the Macapagal-Arroyo administration submitted a P780 billion obligation budget for congressional approval, 11.6% (P80.9 billion) higher year-on-year in nominal terms. The proposed budget is tight, with about 67% (P54 billion) of that increase earmarked for "non-discretionary" items (i.e., personnel-related outlays, debt service payments, and legally mandated transfers to local government units). Overall, the goal for 2002 is to reduce the national government's 2002 fiscal gap to P130 billion (3.3% of GDP) and that of the consolidated public sector to P136.1 billion (3.4% of GDP). These goals form part of a medium-term fiscal program which calls for declining deficits starting in 2002, towards balancing the consolidated public sector and national government budgets by 2005 and 2006, respectively.

The national government's proposed 2002 fiscal plan targets P624.3 billion in revenues, 11.8% (P66.1 billion) higher year-on-year. With non-tax inflows (including proceeds from privatization) expected to slow, the burden next year will fall squarely on meeting tax collection targets. The national government hopes to collect about P571 billion in taxes, up 14.5% (P72.4 billion) from 2001. Roughly 70% of that envisioned increase hinges on a higher real GDP growth rate (4.3% in 2002 versus 2001's downward-revised 3.3% forecast) and the balance on improving the tax-to-GDP ratio from 13.8% in 2001 to 14.4% in 2002. Part of the envisioned tax-to-GDP improvement will depend on how executive-branch proposals — among others, to shift to a modified gross income tax system and to adopt an inflation-indexed excise tax system for cigarettes and liquor — fare in the legislative mill. The current administration faces considerable pressure to deliver on poverty alleviation goals President Macapagal-Arroyo outlined in her first State of the Nation Address on July 23. This places greater pressure on revenue improvements (versus expenditure cutbacks) in the year ahead to keep the national government's fiscal deficit in check.

Beyond the short-term challenges, structurally weak public finances pose a serious threat to the Philippines' long-term growth potential. Weak tax administration has been a long-standing problem merely magnified by the Asian crisis. The Philippines' tax-to-GDP ratio, among the poorest in the region, peaked at no more than 17.1% in 1998 before deteriorating in subsequent years. On the expenditure side, the large (about 70%) share of "non-discretionary budget" items leaves the government with little leeway for fiscal maneuvering without sacrificing essential infrastructure investments and social development objectives. More aggressive efforts and stronger political will are required to achieving long-term fiscal viability. Corruption and inefficient tax collection have increased public resistance to new taxes, as well as eroded the intended gains of past tax restructuring efforts.

The Macapagal-Arroyo government, which has assembled a well-respected fiscal team, deserves praise for its strong resolve to live within its means by exercising fiscal austerity. Initiatives towards improving budgetary discipline and transparency — such as public sector procurement reforms and clearer criteria for prioritizing government projects — are steps in the right direction. However, revenue mobilization remains crucial to sustaining a deficit-reduction plan that supports the socio-economic needs of a growing population and harnesses the human resource and infrastructure capabilities demanded by intensifying global competition.

FOREIGN DEBT RATIOS



	1996	1997	1998	1999	2000	2001
FOREIGN DEBT/GNP (%)	48.6	53.0	69.5	65.1	65.9	70.0*
DEBT SERVICE/ EXPORTS (%)	12.7	11.6	11.7	14.2	12.3	16.3

*Ratio estimated using annualized first semester GNP.

Foreign Debt and Debt Service

The national government, which had originally planned to raise about $1.6 billion in foreign loans during 2001 for deficit financing and debt amortization purposes, has since reduced its foreign borrowing goal to $1.2 billion. The reduced target reflects a cutback in expected official development assistance (ODA) funds to $615 million from nearly $1 billion, reflecting the government's inability to meet performance requirements. To keep pressure off domestic interest rates, the government intends to cover the lower ODA level by reducing its targeted cash build-up for the year.

As of August, the government had raised about $520 million in foreign commercial loans from a combination of private placements and a currency swap arrangement (the first time the country had used a derivative to achieve funding targets). With another private placement under negotiation, the national government has more or less completed its $550 million commercial borrowing goal for the 2001 full year. Escalating jitters over Latin America's debt problems exacerbated uncertainties over emerging-market debt, constraining the attractiveness of international bond offerings. The government is exploring a variety of borrowing instruments to help broaden the capital market (including dollar-linked peso securities, straight dollar bonds, and dollar-denominated T-bills) — targeted mainly for resident investors. If any of these materialize within the year, government finance officials said that the proceeds would be applied mainly to 2002 budget requirements.

To support low domestic interest rates, the government plans to shift the financing burden to foreign borrowings in 2002 to the tune of about $2.8 billion (equivalent to over 50% of total financing requirements, versus 22% this year). About $1.3 billion of that amount will depend on the government's ability to improve utilization of concessional ODA funds, an issue of long-standing concern to foreign donors. The current administration is working to rationalize its $13 billion ODA loan portfolio in order to save on commitment fees and to better prioritize and manage the limited resources currently available for local counterpart financing. As of August, the government had cancelled about $400 million in committed ODA funds.

According to the most recent quarterly estimates, the Philippines' recorded external debt (based on foreign credits approved or registered with the Bangko Sentral ng Pilipinas) stood at $49.9 billion as of end-March 2001. That level represented a 4% ($2.1 billion) decline from end-2000's $52.1 billion level and a 4.7% ($2.5 billion) decline year-on-year. The quarter-on-quarter decline in the foreign debt stock reflected higher net repayments of public and private sector debt, lower commercial bank liabilities, and $1.4 billion in currency revaluation adjustments during the period (mainly a weaker Japanese yen vis-à-vis the US$). Medium and long-term loans (with a weighted maturity of 17 years) constituted nearly 89.6% of outstanding external obligations. Almost half of external obligations were obtained from official creditors (defined as foreign governments and their export credit agencies, and multilateral financial institutions) at more concessional terms.

Although the foreign debt stock declined, the foreign debt service burden — measured as the ratio of debt service payments to merchandise and service export receipts — spiked to 16.2% during the first five months of 2001. The comparable 2000 ratio was 12.4%. The heavier foreign debt service load reflected a $450 million year-on-year expansion in debt service payments and a $1.7 billion year-on-year slump in merchandise export and service receipts. If the ratio holds at about 16% for the full year (as the Bangko Sentral estimates), this will be the highest foreign debt service burden posted since 1995. These developments suggest vulnerabilities to unexpected reversals in export markets — highlighting the importance of addressing the weak state of government finances and attracting more sustainable, non-debt sources of balance of payments financing.

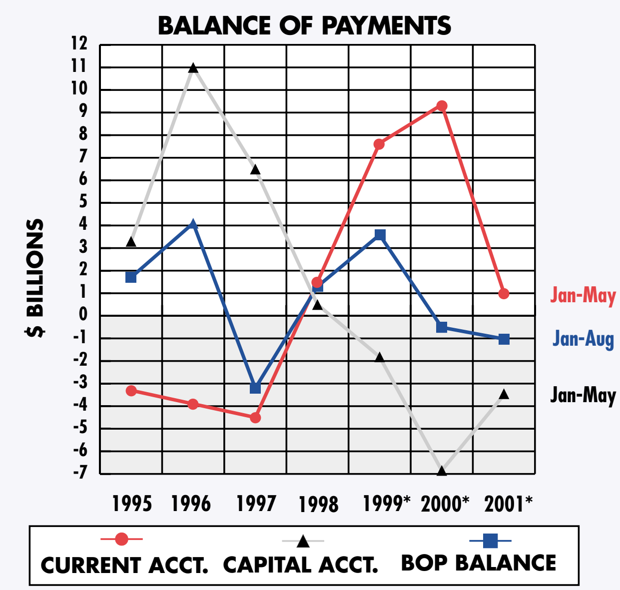
Merchandise Trade and Balance of Payments

The Philippines is headed for a second consecutive year of balance of payments (BOP) deficits after ending 2000 over $500 million in the red. After widening in recent years, the current account surplus has narrowed, combining with the continued weakness in capital and financial flows.

Detailed balance of payments (BOP) statistics showed the Philippines' BOP position at a $797 million deficit as of May 2001. The current account surplus narrowed by 58.7% year-on-year (from $2.5 billion to $1.0 billion) while the capital and financial account deficit widened to $3.4 billion (5.7 times 2000's comparable level). The narrower current account surplus resulted from smaller net receipts from merchandise trade, investment incomes, and overseas workers' remittances. These combined with a larger service account deficit, where a 20% ($368 million) decline in revenues — including a 17% ($182 million) drop in tourism-related receipts — outpaced a 10% ($267 million) contraction in service payments.

In the capital and financial account, net foreign direct investments slumped to $523 million, about half of 2000's comparable five-month level. Meanwhile, net portfolio outflows ballooned from $339 million to $1.5 billion year-on-year mainly because of higher net repayments on maturing foreign debt securities. Higher net outflows in the "other investment" account (consisting of trade credits, loans, and currency and deposits) also contributed to a wider capital and financial account gap.

The global economic and electronics demand slowdown combined with softer prices of resource-based commodities to depress export performance. Export receipts (US$ terms) recorded successive year-on-year declines from February to June, with double-digit negative growth (18.4%) registered during the second quarter. In cumulative terms, first-semester

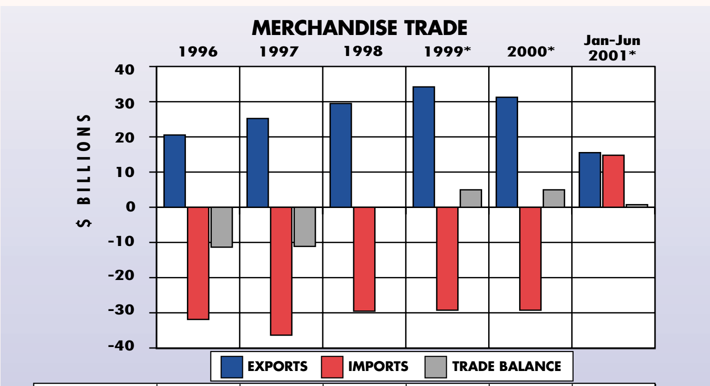


*Revised to reflect recommendations of IMF Technical Mission

merchandise exports dropped 9.7% ($1.7 billion) from 2000's comparable level largely because of a 16.4% slump in shipments of electronic and telecommunications parts and equipment (which constitute about 60% of Philippine export revenues). The first-semester import bill was about flat year-on-year partly because of more stable world crude prices, but imports have not slowed as much as exports because of low inventory levels. Reflecting second-quarter merchandise deficits, the Philippines' trade-in-goods balance narrowed from a $1.3 billion surplus as of March to $739 million as of June — less than a third of 2000's comparable first-semester level.

With hopes dimming for a quick rebound in external markets, merchandise exports appear headed to end the year down from 2000, translating to markedly narrower trade-in-goods and current account surpluses. Full year commodity exports last declined year-on-year in 1985. Although details are not yet available, the BSP estimates the balance of payments deficit (computed from the change in BSP net international reserves) to have widened further to $1 billion as of August.

Although 2001 will mark the third and fourth consecutive years, respectively, of trade and current account surpluses for the Philippines, BOP vulnerabilities remain. The Philippines historically has posted trade and current account surpluses during periods of economic weakness, with risks of reverting to deficits as economic expansion accelerates. While trade liberalization presents vast opportunities, intensifying global competition and the emergence of large, low-wage export economies also pose challenges. Longer-term BOP stability likewise hinges heavily on the Philippines' ability to harness non-debt sources of foreign exchange — particularly foreign direct investments — in a more and more open and competitive world economic environment.



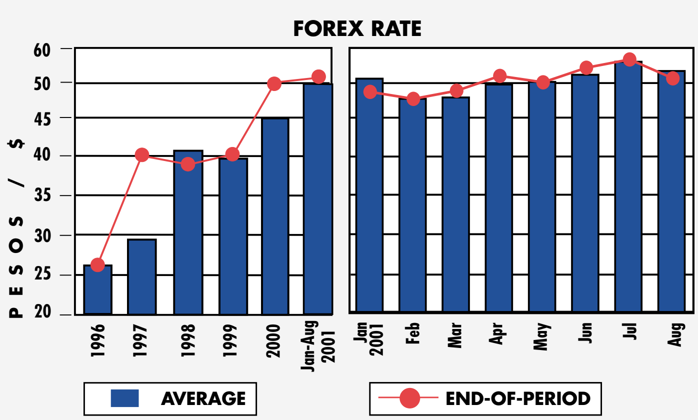
	1996	1997	1998	1999*	2000*	Jan-Jun 2001*
EXPORTS	20.543	25.228	29.496	34.210	31.265	15.522
IMPORTS	-31.885	-36.355	-29.524	-29.251	-29.252	14.783
TRADE SURP/DEFICIT	-11.342	-11.127	-0.028	4.959	4.958	0.739

*Revised to reflect recommendations of IMF Technical Mission

Foreign Exchange Rate and International Reserves

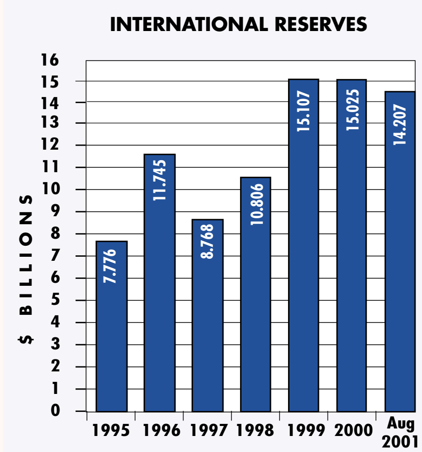
The peso managed to trade between P50 – P51 to the US$ most of May through the first week of June despite election-related uncertainties. The local currency then began to succumb more rapidly to a confluence of domestic and external factors. Deepening worries over the economic crunch in the U.S. and Japan combined with escalating concerns over Latin America's debt problems, exacerbating weak sentiment over emerging-market currencies. A growing balance of payments deficit (headlined by poor export receipts) also contributed to downward pressure on the currency as did negative publicity from spates of unsettling domestic news and rumors (i.e., the Abu Sayyaf hostage drama and more general peace and order concerns). The peso hit an intra-day rate of P54.335/US$ on July 18, the lowest thus far under the Macapagal-Arroyo administration.

The peso has since strengthened, aided by a series of BSP measures directed at curbing speculative and panic-driven foreign exchange purchases. In addition to monetary tightening moves (see section on Financial Markets), the BSP also: lowered banks' and bank-affiliated forex corporations' over-the counter ceiling for foreign exchange sales without documentation from $10,000 to $5,000; expanded coverage of its Currency Risk Protection Program (a non-deliverable forward hedging facility first introduced in December 1997); tightened monitoring of foreign exchange transactions; and occasionally provided liquidity in the inter-bank foreign currency market. During the first week of August, the BSP "named and shamed" nine commercial banks for alleged violations of foreign exchange regulations (in addition to imposing monetary penalties). The peso, which closed at P53.00/US$ on August 9, sharply rebounded to a closing rate of P51.85 on August 10, suggesting that the peso's previous weakness had reflected more than fundamentals. The local currency generally traded in the P50.60 to P51.40 range to close at 51.30/US$ on September 14, partly reflecting weaker sentiment for the U.S. currency. At that rate, the peso was 2.6% weaker than at the end of 2000 and had depreciated by 1.8% from the P50.38 (May 4) closing level which we last reported in the June 2001 *Philippine Economic Outlook*.



*End-of-period data refers to average foreign exchange rate on last trading day of indicated period.

It is too early to gauge whether the peso will more or less hold at current levels in the weeks and months to come, depending in part on actions the U.S. takes in reaction to weaker sentiment for its currency. Domestically, budget deficit control, if sustained, and more moderate inflation will be plus factors for a stable peso. On the other hand, uncertainties abound on how the recent event and unfolding developments in the U.S. could affect foreign exchange liquidity (given already depressed Philippine exports and balance of payments flows) and overall confidence.



Developments in the balance of payments combined with efforts to temper foreign exchange volatility to further reduce the international re-serve cushion of the Bangko Sentral ng Pilipinas. From $14.5 billion as of end-April, the BSP's gross international reserves (GIR) stood at $14.2 billion as of end-August. While international reserves de-clined in nominal terms, lethargic im-ports have so far prevented a radical fall in terms of months of import cover. The end-August GIR cushion equaled 4.2 months worth of goods and services imports (compared with end-2000's buffer of 4.4 months and end-April 2001's cushion of 4.3 months). That cushion also equaled 118% of public and private sector debt maturing over the next twelve months. Considered as "secondary reserves," the BSP estimated that banks' foreign currency deposit units (FCDUs) had about $13.3 billion in deposits as of end-2000, nearly 90% of which represented deposits of Philippine residents.

Poverty

In August, the Philippine National Statistical Coordination Board (NSCB) released poverty statistics for 2000. These estimates are computed mainly from the Family Income and Expenditure Surveys that the government conducts every three years. The 2000 statistics showed that the incidence of poverty (computed as the ratio of the "poor" population — i.e., those unable to afford basic food and non-food requirements — to the total population) inched up from 36.8% in 1997 to 40% in 2000. That translates to about 4.5 million Filipinos joining the ranks of the poor between 1995 and 2000. The higher incidence of poverty has been attributed to the Asian financial crisis, extreme weather disturbances (El Niño and La Niña), and political uncertainties — all of which

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tended to constrict job generation, investments, and incomes. More candid observers note that especially poor public sector governance exacerbated the situation.

The 2000 statistics represent a setback to the steady declines in poverty incidence recorded since 1988. The numbers also show large disparities in poverty incidence across the sixteen administrative regions — ranging from a low 12.7% (National Capital Region) to a high 69.8% (Autonomous Region of Muslim Mindanao). The disparity between urban and rural areas (25% and 54%, respectively) is also large and widened somewhat over the past five years.

President Macapagal-Arroyo, who has boldly articulated her goal of stamping out poverty within the decade, faces a daunting challenge. As borne by the experience of the past 1-1/2 years, high poverty rates can impinge on political stability. In the Philippines, poverty alleviation goals are complicated by a high population growth rate (2.36% per year), inequitable income distribution (i.e., the richest 30% of families receive more than two-thirds of national income, and the poorest 30% of families barely 8%), and weak public sector finances.

The policies for making significant inroads in reducing poverty have been laid out by the current administration in its 2001-2004 medium-term economic plan. They center on fiscal discipline, good governance, market-oriented reforms, and comprehensive human development. Most of these challenges are not new and the real key to success will be a sustained effort and determined political leadership.

Challenges and Prospects

The global slowdown and the shadow cast over the world economy by the terrorist attacks in the United States have made the Philippines' uphill economic climb all the more challenging. In this context, the likelihood that there will be positive economic growth in the Philippines is evidence of a certain resiliency in the economy, provided by a combination of billions of dollars in remittances from overseas workers, and growth in the domestic economy in areas such as retail sales. When measured against the Philippines' high rate of population growth (over 2.3 percent annually), however, the impact of economic growth in the range of 3% – 4% will be minimal.

There are many difficult challenges. Perhaps the most pressing is the need to get the budget deficit under control, and to increase government revenues for the long run. The Arroyo Administration's proposed 2002 budget is almost 12% higher than this year, and will be financed largely from projected increased tax revenues. Roughly two-thirds of these revenues, however, would result from higher projected economic growth, and the rest from executive and legislative initiatives that may or may not be successful. The government must be flexible and be prepared to make adjustments to keep within its fiscal targets. Indications on this score so far are encouraging. On foreign debt, however, vulnerabilities remain. Although the foreign debt stock has declined, the foreign debt service burden increased this year (as a result of declining exports), highlighting the need to move to non-debt sources of financing.

In another area, protests against the government's efforts to modernize agriculture by groups opposed to genetically modified agricultural products pose a challenge to both economic progress and law and order. The trial of former President Estrada promises to keep many unsavory aspects of Philippine politics and corruption under his administration on the front page of the news, and could prove to be a serious distraction for the new government. Another problem the administration may face is how to handle the hundreds of thousands of Filipino overseas workers in the Middle East in the event of a conflict in the region; if significant numbers of workers return home, there would be a reduction in the overseas remittances that provide ballast for the domestic economy, plus additional pressure to find jobs in the Philippines.

The Arroyo Administration has been praised for its business-like approach to government, its focus on private enterprise, and the expertise of its cabinet members. Its skill in successfully passing legislation on power sector reform will be put to the test in the coming weeks and months as power sector privatization proceeds, and other reform measures are taken up. Other challenges include efforts to modernize the investment framework by harmonizing existing fiscal incentive regimes and adopting new investment legislation, and by initiatives to further strengthen bank supervision and intellectual property rules and enforcement. The task for the government will be to maintain its focus on a reform agenda, notwithstanding pressing economic and other domestic problems, and a slowdown in the world economy.

PROJECTIONS FOR 2001: SELECTED INDICATORS

	1999 Actual	2000 Actual	2001 Forecast[a]
GDP Growth (Year-on-Year, %)	3.3	3.9	2.5-3.0
GNP Growth (Year-on-Year, %)	3.7	4.2	2.8-3.3
Average Year-on-Year Inflation (1994=100, in %)	6.6	4.4	6.2-6.5
Average 91-day T-bill Rate (%)	9.99	9.94	9.7-10.1
Average Forex Rate (Pesos/US$)	39.04	44.19	50.80-51.10
Exports ($Billions)	34.2	37.3	31.7-32.5
Growth (Year-on-Year, %)	18.8	9.0	(13.0-15.0)
Imports ($Billions)	29.3	30.4	31.0-31.3
Growth (Year-on-Year, %)	4.1	3.9	2.0-3.0
Trade Balance ($Billions)	4.9	6.9	0.7-1.2

[a]Embassy projections as of September 2001

Sources: National Economic and Development Authority, Bureau of Treasury, Bangko Sentral ng Pilipinas

PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	1999	2000	2001	
Domestic Economy				
Population (millions, 2000 census)	74.7	76.5	78.3	
Population growth (%)	2.36	2.36	2.36	
GDP (current) ***a/***	76,155	74,736	68,140	annualized first semester figures
GNP (current) ***a/***	80,229	79,003	72,022	
Per Capita GDP, current dollars ***a/***	1,019	977	870	
Real GDP (% change, yr.-on-yr.)	3.4	4.0	3.3	Jan-Jun
Real GNP (% change, yr.-on-yr.)	3.7	4.5	3.4	Jan-Jun
Consumer Price Index (ave. % change, yr.-on-yr. 1994=100)	6.7	4.4	6.6	Jan-Aug
Production, Employment, Fiscal Accounts				
Unemployment rate (%) ***b/***	9.8	11.2	12.3	Jan/Apr
Industrial prod. (1985=100), % change yr.-on-yr.	0.9	3.9	2.7	Jan-Jun
Nat'l gov't budget surplus/(deficit) ***a/***	(2,856)	(3,080)	(1,637)	Jan-Jul
as % of GNP	(3.6)	(3.9)	(3.9)	Jan-Jul
Consolidated public sector surplus/(deficit) ***a/***	(2,570)	(3,481)	(1,650)	Jan-Jun
as % of GNP	(3.2)	(4.4)	(4.6)	Jan-Jun
Interest Rates (%)				
Weighted average T-bill rate (all maturities)	10.67	11.15	11.04	Jan-Aug
Average prime loan rate	12.6	12.9	14.1	Jan-Jul
Balance of Payments *f/*				
Exports (FOB)	34,210	37,295	15,522	Jan-Jun
Growth (%, yr.-on-yr.) ***f/***	18.8	9.0	(9.7)	Jan-Jun
Imports (FOB)	29,252	30,380	14,783	Jan-Jun
Growth (%, yr.-on-yr.) ***f/***	4.1	3.9	(0.1)	Jan-Jun
Trade balance	4,958	6,915	739	Jan-Jun
Current account surplus (deficit)	7,647	9,349	1,017	Jan-May
as % of GNP	9.5	11.8	3.4	Jan-May
BOP surplus/(deficit)	3,588	(513)	(1,024)	Jan-Aug
Foreign Debt, as of end of period *c/*	52,210	52,060	49,949	March
Debt service paid	6,709	6,068	2,795	Jan-May
Debt service (% of exports of goods and services)	14.2	12.3	16.2	Jan-May
BSP International Reserves, as of end of period	15,107	15,025	14,207	Aug
Exchange Rate (pesos/$)				
Average exchange rate	39.09	44.19	50.64	Jan-Aug
Closing ave. exchange rate ***d/***	40.30	49.99	51.02	Aug
Foreign Direct Investment (BSP registrations) *e/*				
Total (cumulative, since 1973)	11,412	12,810	13,100	May
U.S. (cumulative, since 1973)	2,806	3,052	3,104	May
U.S. share (%)	24.6	23.8	23.7	May
U.S.-Philippine Trade (Phil. Data)				
Philippine exports to U.S., FOB	10,445	11,381	4,481	Jan-Jun
Growth (%, yr.-on-yr.)	3.4	9.0	(12.5)	Jan-Jun
Philippine imports from U.S., FOB	6,365	4,879	2,736	Jan-Jun
Growth (%, yr.-on-yr.)	(3.0)	(23.3)	(2.8)	Jan-Jun
Philippine trade balance with U.S.	4,080	6,501	1,745	Jan-Jun
U.S. share of Philippine imports (%)	21.8	16.1	18.5	Jan-Jun

a/ originally peso values, converted to USD; ***b/*** annual figures computed as average of quarterly surveys (Jan/Apr/Jul/Oct); ***c/*** excludes "net due to" accounts of foreign commercial banks and private sector loans not approved and/or registered by/with the BSP; ***d/*** average on last trading day of indicated period; ***e/*** principally exercised to enable foreign exchange purchases from the banking system for capital repatriation and profit remittances; ***f/*** 1999 and 2000 figures reflect recent IMF-recommended technical revisions (but 1999 export and import growth rates were computed using unrevised 1999 data for comparability with 1998 figure);

Sources: National Economic and Development Authority; Department of Finance; Bureau of the Treasury; Bangko Sentral ng Pilipinas